

*United States Court of Appeals  
for the Second Circuit*



**BRIEF FOR  
APPELLANT**



*signed*

**74-1166**

IN THE UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

PHILIP HANDELMAN and ESTHER HANDELMAN,  
Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,  
Appellant

ON APPEAL FROM THE DECISION OF THE  
UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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BRIEF FOR THE APPELLANT

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STATEMENT OF THE ISSUES PRESENTED

1. Whether the Tax Court erred in holding that \$95,000 received by taxpayer represented payments from the sale or exchange of certain stock held by him in Graphic Arts Exhibit Building, Inc., and accordingly qualified for capital gain treatment.
2. Whether the Tax Court erred in allowing taxpayer to report the \$95,000 in payments received by him on the installment method of accounting.
3. Whether the Tax Court, in holding that taxpayer was entitled to deduct 60 percent of the amounts claimed for the years 1963 through 1965 as expenses for the maintenance and operation of his 46-foot sailing sloop, failed to properly

apply the disallowance and substantiation rules of Section 274 of the Internal Revenue Code of 1954 and the Treasury Regulations promulgated thereunder.

STATEMENT OF THE CASE

This appeal involves deficiencies in tax initially determined by the Commissioner in taxpayer's<sup>1/</sup> income tax for the years 1951 through 1965, inclusive. (R. 10-20.)<sup>2/</sup> The Tax Court's memorandum findings of fact and opinion (R. 152-176), which is unofficially reported at P-H Memo T.C., par. 73,057, was filed on March 7, 1973, and the court's decision in respect thereof was entered thereafter on August 16, 1973 (R. 180). The notice of appeal was timely filed on November 13, 1963. (R. 182-183.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts, as found by the Tax Court and as otherwise disclosed in the record, may be summarized as follows:

I

Taxpayer organized Graphic Arts Exhibit Building, Inc. (hereinafter referred to as Graphic Arts or the corporation) for the purpose of constructing and then leasing space in a

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<sup>1/</sup> Philip Handelman will be referred to hereinafter as the taxpayer. Esther Handelman is a party solely by virtue of the fact that she and taxpayer filed joint returns for the years in issue.

<sup>2/</sup> "R." references are to the separately bound record appendix; "Ex. Vol." references are to the separately bound exhibit volume.

building at the site of the New York World's Fair 1964-1965. (R. 55, 154-155; Ex. Vol. 28-29.) In June of 1961, taxpayer entered into an employment agreement with Thomas R. O'Connor, under which O'Connor was to be employed by Graphic Arts and also was to acquire "a little stock interest" in the corporation. (R. 56, 155.) Shortly thereafter, O'Connor offered to purchase all the stock of the corporation. In the negotiations which followed, O'Connor acted on behalf of himself and Joan Van de Maele, who was his partner and financial backer. (R. 56, 75, 155.)

The Tax Court found that O'Connor, Van de Maele and taxpayer "agreed" in December, 1961, that O'Connor and Van de Maele would purchase certain shares of taxpayer's stock in Graphic Arts.

(R. 155-156.) During 1961, Van de Maele paid taxpayer \$25,000, to which he ultimately became entitled when one of the several escrow arrangements, described hereafter, failed to close because Van de Maele and O'Connor were unable to meet certain conditions thereof. (R. 63-64.)

On December 8, 1961, Van de Maele executed two notes, payable to taxpayer on June 8, 1962, in the respective amounts of \$50,000 and \$17,000. At the same time, Van de Maele and O'Connor executed a note in the amount of \$48,000, payable to Dr. A. Alfred Solomon, who was another shareholder of Graphic Arts. (R. 155-156; Ex. Vol. 42, 55-56.) These notes were related to the agreement of O'Connor and Van de Maele to purchase the stock of taxpayer, and to a separate agreement to purchase the shares owned by Dr. Solomon. (R. 156; Ex. Vol. 43.)

The alleged agreement of December, 1961, was not introduced into evidence, although requested by the Court. (R. 59, 62.) However, the record otherwise discloses that it apparently pertained to 59 shares of Graphic Arts stock owned by taxpayer and 24 shares belonging to Dr. Solomon. (Ex. Vol. 43.) As described hereafter, the aggregate number of shares, 83 in this instance, involved in taxpayer's negotiations with Van de Maele and O'Connor, was substantially altered at each stage of the various arrangements between the parties. At one point the total was 88 shares, at another it was 104 shares, and at still another point it was 64 shares. Moreover, the consideration which O'Connor and Van de Meale were to pay for the shares also varied in each of the attempted transactions. (R. 63-68, 156-157, 160, 162; Ex. Vol. 20-21, 69, 78, 79.) No shares of Graphic Arts stock, however, were, in fact, ever delivered to Van de Maele or O'Connor prior to 1970, by which time the corporation had been dissolved; further, Van de Maele and O'Connor never otherwise acquired any of the rights or obligations attaching to any of the corporation's stock in the interim. (R. 63-64, 82, 157-160, 162; Ex. Vol. 20-21, 23, 24, 28-29, 69, 78, 79.) Indeed, the corporation never, in fact, constructed the exhibit facility at the World's Fair 1964-1965, and ultimately defaulted on its lease of the building site. (R. 69, 75.)

On February 20, 1962, and thereafter on March 26, 1962, Van de Maele made additional payments to taxpayer in the amounts

of \$30,000 and \$40,000, respectively. (R. 156; Ex. Vol. 30, 31-32.) While taxpayer's testimony about these two payments is somewhat unclear, it does appear that these payments, like the \$25,000 received by taxpayer in 1961, were related to the various escrow arrangements entered into in respect of Van de Maele's and O'Connor's several attempts to purchase different amounts of taxpayer's Graphic Arts stock. (R. 63-64, 66-67, 68, 73-74.) Neither these payments of \$30,000 and \$40,000, nor the \$25,000 payment received by taxpayer in 1961, were applied in reduction of the two notes payable to taxpayer which were executed by Van de Maele on December 8, 1961. On or about June 8, 1962, these notes were duly presented for payment, but returned unsatisfied. (R. 156; Ex. Vol. 17, 39-41, 75, 76.)

Thereafter, by an agreement dated June 13, 1962, the terms of the "proposed sale" (R. 157) were modified. O'Connor and Van de Maele jointly executed an additional note in the amount of \$59,000. The agreement of June 13, 1962, pertained to this new note as well as to the two previous notes payable to taxpayer in the respective amounts of \$50,000 and \$17,000, and to the \$48,000 note payable to Dr. Solomon. It otherwise related to 88 shares of Graphic Arts stock, not the previous number of 83 shares, and provided that the voting rights of the stock were to remain with taxpayer during the escrow and that, in the event the notes were not paid by the closing date, the stock was to be returned to him. (R. 69-70.) Although the closing date of the escrow was extended to July 11, 1962, none of the

four notes covered by the agreement of June 13, 1962, were paid, and the escrow was accordingly terminated and the stock returned to taxpayer. (R. 63-64, 159-160; Ex. Vol. 14-15, 77.) In addition, upon the termination of the escrow of the shares, taxpayer alone became entitled to retain the \$25,000 payment made to him in 1961 by Van de Maele. (R. 63-64, 68.)

Thereafter, on or about March 14, 1963, a second escrow arrangement was entered into by taxpayer. However, the terms of this escrow differed substantially from those of the prior escrow agreement of June 13, 1962. Under the March 14, 1963, escrow, taxpayer deposited into escrow 104 shares of Graphic Arts stock, or 16 more shares than were covered by the escrow of June 13, 1962. Moreover, under the new escrow instructions, taxpayer was personally to receive \$150,000, or \$24,000 more than was payable to him in respect of the various notes in his favor which were referred to in the escrow of June 13, 1962. (R. 66-74, 160-161; Ex. Vol. 78.) Indeed, it is clear that this new escrow arrangement now did not include the shares of Graphic Arts stock held by Dr. Solomon, since the \$150,000 involved merely covered this additional \$24,000, plus the three notes payable to taxpayer in the amounts of \$50,000, \$17,000, and \$59,000. (R. 160; Ex. Vol. 39, 54-56.) The closing date of the escrow arrangement of March 14, 1963, was extended by still another escrow dated March 20, 1963. Both of these escrow arrangements provided that the stock was to be returned in the event the payment out of escrow was not made to taxpayer. The payments were in fact not made, and the escrow was terminated. (R. 78-82, 160-)

161; Ex. Vol. 78, 79.)

The payments of \$30,000 and \$40,000 made to taxpayer by Van de Maele in February and March of 1962, respectively, were received by taxpayer in respect of his agreement to enter into the several escrow arrangements of June 13, 1962, and of March, 1963. And, as with the \$25,000 payment which he received in 1961, taxpayer retained the \$30,000 and \$40,000 payments when the escrows failed to close because Van de Maele and O'Connor did not meet certain of the conditions thereof. (R. 63-64, 66, 67-68, 73-74, 111, 156.)

After the termination of the final escrow of March, 1963, taxpayer initiated an action in the Supreme Court of the State of New York against Van de Maele and O'Connor. In this action, taxpayer did not sue upon any purportedly enforceable contract of sale, but merely sought to recover on the three notes payable to him in the aggregate amount of \$126,000 (i.e., \$50,000, \$17,000, and \$59,000, respectively) and the additional \$24,000 to be paid to him under the escrow arrangements of March, 1963. (R. 161; Ex. Vol. 7-11, 49-53.) In their answer, Van de Maele and O'Connor asserted as an affirmative defense the clause of the escrow agreement of June 13, 1962, and the similar provisions of the escrow arrangements of March, 1963, which directed the escrow agent to return the stock to taxpayer in the event the notes were not paid. They claimed that these provisions comported with an oral understanding of the parties to the effect that any agreement to purchase the stock would be cancelled if Van

de Meale and O'Connor were unable to satisfy the notes. (Ex. Vol. 14-17, 57-74.) In granting taxpayer's motion for summary judgment on the three notes, the New York State court held that such parol evidence was impermissible to raise a defeasance provision in derogation of the unconditional terms of the promissory notes. The court accordingly otherwise denied taxpayer's motion for summary judgment insofar as it related to the additional \$24,000 "not proved by document." (R. 161-162; Ex. Vol. 15-16, 35-36.)

Ultimately, in April, 1971, the litigation in the New York State court brought by taxpayer against Van de Maele and O'Connor was settled. Van de Meale and O'Connor paid taxpayer an additional \$89,500 in return for a general release, the three notes held by him, and certificates representing 64 shares of Graphic Arts stock. By this time, the corporation had already been dissolved by proclamation of the Secretary of the State of New York for nonpayment of taxes. (R. 73-77, 162; Ex. Vol. 20-22, 23, 24, 28-29.)

In his deficiency notice, the Commissioner determined that the \$95,000 in payments, which had been retained by taxpayer when Van de Maele and O'Connor's several attempts to purchase taxpayer's Graphic Arts stock were in "final default", constituted ordinary income. The Commissioner also determined the deficiency in tax on the basis that taxpayer was not entitled to the installment method of reporting. (R. 15-16.) The Tax Court held that the \$95,000 in question was long-term gain

from the sale of a capital asset, and also permitted taxpayer to report such gain on the installment method. (R. 164-171.) The Commissioner appeals from this decision. (R. 182-183.)

## II

During the taxable years in question, taxpayer was a practicing attorney in the State of New York. He specialized principally in litigation, and to a substantial extent clients were obtained by him through referrals, for which he paid large fees to other attorneys in all the years in issue. (R. 145-147; Exs. C (Schedule C), D (Schedule C), E (Schedule C) and 6-F (Schedule C, Line 17, Legal Fees Paid To Other Attorney).)

Taxpayer also was a well-known and an accomplished sailing enthusiast. He began to sail in the 1930's, and has won several races, including the Bermuda race. (R. 141, 163.) During the period 1963 through 1965, taxpayer continued to race his boat, the Chee Chee V, a 46-foot offshore sailing yacht, in about five or six races each year. (R. 87-88, 92, 125, 127-128, 135-138, 141, 162-163; Ex. Vol. 4.) Taxpayer also incurred certain expenses in the use of the Chee Chee V for entertainment purposes, which he alleged were related to his business as a practicing attorney, and in respect of which he claimed business expense deductions in his tax returns for 1963 through 1965, inclusive. (Ex. Vol. 4; Exs. C (Schedule C), D (Office Expenses), E (Office Expenses), and 6-F (Schedule C-1).)

In respect of the entertainment functions on the boat for which he claimed the deductions in question, taxpayer apparently used the sailing sloop on some occasions as a means of generating

goodwill among persons he hoped would become his clients. He variously testified that the boat was employed "with the idea of creating clients and obtaining legal retainers," and "to cultivate prospective clients." (R. 88, 90-91, 102-103, 127-128, 129.) The record contains no evidence that any specific business discussions were carried on during any of these events. Indeed, taxpayer testified that he refrained from asking guests even to sign a log on the boat, or overtly keeping such records in respect of his allegedly business-related use of the yacht, because such a practice would have defeated the glamorous image he wished to create. (R. 89, 91-92, 102, 105.) Rather, the boat was devoted exclusively to the "glamour" of entertaining (R. 102) and "comfortable" sailing, or to the singular and all-consuming efforts of racing (R. 134.)

In his deficiency notice, the Commissioner disallowed all the deductions claimed for boat expenses in taxpayer's returns for 1963 through 1965, on the ground that such expenses did not meet the requirements of Section 274 of the Internal Revenue Code. (R. 16, 17, 18.)

In addition to his own testimony, the only other evidence presented by taxpayer at the hearing before the Tax Court consisted of the testimony of his secretary, and certain summaries prepared by the secretary from diaries and telephone logs. (R. 87-105, 119-150; Ex. Vol. 95-99, 102-104, 106-108.) His secretary's testimony revealed that the telephone logs and the diaries, and, therefore, the summaries themselves, did not disclose every

use of the boat, but only those specific uses arranged through taxpayer's office. (R. 95.)

The record before the Tax Court contained no evidence, derived from any of these sources, concerning taxpayer's total use of the boat. Moreover, the record otherwise contained no evidence that the boat expenses were in any amount directly related to specific business discussions aboard the yacht.

On this evidence, the Tax Court concluded that taxpayer satisfied the requirement set forth in Section 274 that an entertainment facility such as a boat be used "primarily" for business purposes. (R. 174-175.) The Tax Court then allocated 60 percent of the total boat expenses claimed by taxpayer to what the Court termed taxpayer's "business use" (R. 175) of the facility, on the basis that a similar allocation had been agreed to by the parties in respect of the tax years 1961 and 1962, years which were prior to the enactment of Section 274 of the Internal Revenue Code of 1954. (R. 112-113, 175-176.) The Commissioner also appeals from this decision. (R. 182-183.)

#### SUMMARY OF ARGUMENT

1. It is well settled that payments received by a taxpayer in respect of an executory and ultimately uncompleted agreement are not to be afforded the benefits of the capital gain provisions of the Code. In such a situation, taxpayer not only receives the payments in question but also retains control and dominion over the capital asset itself. The record in this case discloses that on several distinct occasions Van de Meale and O'Connor attempted unsuccessfully to purchase varying

quantities of taxpayer's Graphic Arts stock for different amounts. While several agreements to purchase the stock may have been contemplated, none were ever consummated. No stock was delivered to Van de Maele and O'Connor prior to 1970, by which time the corporation was defunct, and taxpayer otherwise retained all the rights attaching to the stock. The \$95,000 in payments then, to the extent they were not fees for legal services, were received by taxpayer in respect of his agreement to escrow different amount of his stock on several different occasions. When the various escrows failed to close, taxpayer retained the \$95,000. The \$95,000 was, therefore, clearly not received from the sale or exchange of the stock. Rather, the payments were compensation for services or in the nature of liquidated damages, but in either event, are taxable to taxpayer as ordinary income.

2. Since there occurred in this case no sale or exchange or other disposition of the Graphic Arts stock, it must follow that taxpayer is not entitled to report the \$95,000 on the installment method. In fact, in no event could the taxpayer avail himself of the benefits of installment reporting. The several arrangements between taxpayer and Van de Maele and O'Connor involved different amounts of stock for varying amounts of consideration. These circumstances make it impossible to determine the factors necessary for computation installment profits.

3. Section 274, Internal Revenue Code of 1954, was enacted to eliminate tax abuses which had developed in respect of entertainment expense deductions. With respect to entertainment

facilities, Section 274(a)(1)(B) of the Internal Revenue Code of 1954 requires taxpayer to establish that the yacht was "used primarily" for business purposes and, moreover, that each "item" of expense was "directly related to the active conduct" of business. In addition, Section 274(d), and the Treasury Regulations promulgated thereunder, impose upon taxpayer the responsibility of substantiating the expenses claimed.

(a) The "primary use" of a facility is established by showing that more than 50 percent of the total days of use were days of business use. The Tax Court acknowledged that taxpayer did not establish the total days of use or the part thereof which were related to personal use of the yacht. It was, therefore, error to conclude that the facility was used primarily for business purposes.

(b) Taxpayer must also establish, in addition, that each "item" of expense was "directly related to the active conduct" of business. Sec. 274(a)(1)(B). In enacting this language in Section 274(a)(1)(B), Congress specifically intended to disallow deduction of expenses related to entertainment facilities when such facilities were used merely for the creation or maintenance of goodwill. Accordingly, it has recently been held that such expenses are not "directly related to the active conduct" of business. Hippodrome Oldsmobile, Inc. v. United States, 474 F. 2d 959 (C.A. 6, 1973); D.A. Foster Trenching Co., Inc. v. United States, 473 F. 2d 1308 (Ct. Cl., 1973). The record in this case discloses that at most taxpayer used his yacht to establish goodwill among persons he hoped would become his clients. There

is no evidence on the record which indicates that the expenses claimed by taxpayer were "directly related to the active conduct" of his business.

(c) In enacting Section 274(d), Congress intended to overrule the so-called Cohan rule which permitted an approximation of expenses actually incurred for deductible purposes. Section 274(d) consequently requires taxpayer to precisely substantiate entertainment expenses claimed for business purposes. Taxpayer, however, failed to substantiate the expenses involved in this case, either by records or otherwise. The Tax Court, nonetheless, allowed taxpayer to deduct 60 percent of his boat expenses on the basis of a settlement between the parties in respect of the two previous years not covered by Section 274 of the Code. This settlement, however, has no intrinsic probative value for the later years, much less for years controlled by the strict substantiation requirements of Section 274(d). The clear effect of the Tax Court's decision, therefore, is to resurrect the Cohan rule, in contravention of the specific legislative pronouncement to lay that rule to rest.

#### ARGUMENT

##### I

THE \$95,000 IN PAYMENTS RECEIVED BY TAXPAYER DID NOT REPRESENT PROCEEDS FROM THE SALE OR EXCHANGE OF TAXPAYER'S GRAPHIC ARTS STOCK AND ACCORDINGLY CONSTITUTED ORDINARY INCOME

It is well settled that payments received by a taxpayer in respect of an executory and ultimately uncompleted agreement are not to be afforded the benefits of the capital gain provi-

sions of the Code. Smith v. Commissioner, 50 T.C. 273 (1968), aff'd per curiam, 418 F. 2d 573 (C.A. 9, 1969) (deposit on contract to purchase stock treated as ordinary income to seller when purchase not completed); Binns v. United States, 385 F. 2d 159 (C.A. 6, 1967), aff'g 254 F. Supp. 889, 891 (M.D. Tenn., 1966) (amount of down-payment which seller retained when other party failed to complete purchase of stock was ordinary income even in absence of liquidated damages provision); Myers v. Commissioner, 287 F. 2d 400 (C.A. 6, 1961), cert. denied, 368 U.S. 828 (1961) (amount paid on purchase price of real estate which seller retained after repossessing property two years after agreement of sale was ordinary income); Mittleman v. Commissioner, 56 T.C. 171, 178-179 (1971), aff'd, 464 F. 2d 1393 (C.A. 3, 1972) (advance on purchase of stock retained by seller when purchaser withdrew treated as ordinary income); Melone v. Commissioner, 45 T.C. 501 (1966) (amounts received by seller upon settlement of litigation over purchaser's failure to complete purchase of residential property treated as ordinary income because seller regained possession upon purchaser's default and sale never completed); Boatman v. Commissioner, 32 T.C. 1188, 1192 (1959) (amounts received by seller from settlement, entered into when agreement for sale of farm could not be completed, treated as ordinary income, since no sale or exchange ever occurred); Johnson v. Commissioner, 32 B.T.A. 156, 161 (1935) (amounts received by seller when purchaser failed to complete purchase of stock treated as ordinary income). See also, United States Freight Co. v. United States, 422 F. 2d 887 (Ct. Cl., 1970),

affording a purchaser ordinary loss treatment for the down-payment sacrificed by it when the intended purchase of certain stock was not completed and, therefore, no sale or exchange occurred. Cf. Sec. 1222(3), Internal Revenue Code of 1954, Appendix, infra. There is in such a case neither a sale nor an exchange of the seller's capital asset; he not only receives the payments in question, but also retains control and dominion over the capital asset itself. Smith v. Commissioner, supra, pp. 279-280; Boatman v. Commissioner, supra, p. 1192; Johnson v. Commissioner, supra, p. 161; Mechanic v. Commissioner, supra. See, United States Freight Co. v. United States, supra, p. 893.

The record in this case discloses that on several occasions Van de Maele and O'Connor attempted (unsuccessfully) to purchase varying quantities of taxpayer's Graphic Arts stock for different amounts. (Ex. Vol. 43-46, 69-70, 78, 79.) While several agreements to sell the Graphic Arts stock may have been contemplated by the parties, it is clear that none of these agreements was ever consummated. From 1961 until the settlement stipulation in April, 1970, by which time the corporation had already been dissolved, no stock was ever delivered to either Van de Maele or O'Connor, nor were any of the rights attaching to the Graphic Arts stock ever surrendered by taxpayer. The result of the various escrow agreements, and their subsequent terminations, was that taxpayer retained all the voting rights in respect of the shares, a circumstance strongly indicative that a sale of the stock was never culminated. Kuehner v. Commissioner, 214 F. 2d 437, 441 (C.A. 1, 1954). In fact, the various payments

here in issue were received by taxpayer, according to his own testimony, specifically to secure his agreement to escrow the particular number of his Graphic Arts stock to which each attempted transaction related. (R. 63-64, 66, 67-68, 73-77, 111.) Taxpayer testified that upon the termination of the escrow agreement of June 13, 1962, he simply became entitled to the \$25,000 payment made in respect thereof. (R. 63-64, 68, 73-74.) Such was also the case with the \$30,000 and \$40,000 payments (R. 66-67, 68, 73-74), although, the record is less clear in respect of these latter two payments. (But in this respect it was taxpayer who had the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933)). As the several escrow arrangements terminated, taxpayer merely retained the various payments received by him. Indeed, no part of the \$95,000 was ever applied in reduction of the various notes given to him in respect of the purported purchase of the Graphic Arts stock.

In the circumstances, it certainly cannot be said that the \$95,000 was received from the sale or exchange of a capital asset. Rather, for federal income tax purposes, the payments were significantly more in the nature of liquidated damages under the various agreements to sell the Graphic Arts stock, and as such are taxable as ordinary income. <sup>3/</sup> Smith v. Com-

<sup>3/</sup> Taxpayer, in fact, reported the first of the three payments which are here at issue (i.e., the \$25,000 payment received in 1961) as ordinary income arising from his law practice. (R. 155.) Indeed, taxpayer initially reported only \$55,000 of the \$95,000 in issue, claiming the other \$30,000 as capital gain. (R. 111; Exhibit C.) He now argues that all \$95,000 constituted capital gain.

missioner, supra; Mittleman v. Commissioner, supra; Melone v. Commissioner, supra; Boatman v. Commissioner, supra; Johnson v. Commissioner, supra. In this respect, it is not necessary that there have been a specific liquidated damages or similar provision in any of the escrow agreements pertaining to the several components of the \$95,000 in question. Binns v. United States, supra; Myers v. Commissioner, supra; Melone v. Commissioner, supra. What is more determinative is that the embryonic and executory transactions never culminated in the sale of the Graphic Arts stock, and that the payments accordingly were not made or received in respect of such a sale or exchange.<sup>4/</sup> See United States Freight Co. v. United States, supra, p. 894.

The Tax Court's reliance on Rule 1 of Section 100 of the Personal Property Law, McKinney's Consol. Laws of N.Y. Ann., is simply misplaced. That section deals with general "Rules for ascertaining intention" as to when "the property in the goods is to pass to the buyer." Stock transfers, however, are governed specifically by Section 162 of the Personal Property Law, McKinney's Consol. Laws of N.Y. Ann., which requires that "Title \* \* \* to shares \* \* \* can be transferred only" by

<sup>4/</sup> The settlement agreement of April, 1970, clearly did not effect a sale or exchange of the Graphic Arts stock. By the time the settlement was entered into the corporation had been defunct for several years. The delivery of the certificates, representing the 64 shares of Graphic Arts stock to which the settlement pertained, was merely a formality of the settlement itself. Cf. Melone v. Commissioner, 45 T.C. 501 (1966).

delivery of the certificates, either endorsed or with an accompanying assignment or power of attorney.<sup>5/</sup> Indeed, even where a contract for the sale of stock becomes unconditional by virtue of the fulfillment of a contingency, and the seller brings suit on the purchase price, it is acknowledged that no transfer takes place under Section 162. And, when such an action is based on a theory that the contract effected a transfer of title, this is merely a "legal fiction," which does not presuppose that the purchaser will ever actually obtain the stock in question.

Phelps-Stokes Estates v. Nixon, 222 N.Y. 93, 100-102 (1917).

In any event, such fictions are not controlling for the purposes of federal income taxation, which is concerned more with the "benefits and responsibilities associated with legal ownership."

Titcher v. Commissioner, 57 T.C. 315, 323 (1971). Cf. Mechanic v. Commissioner, 19 T.C.M. 667, 668 (1960).

The Tax Court's view of the transactions here at issue was to concentrate on whether there occurred a technical forfeiture.<sup>6/</sup>

<sup>5/</sup> Both Sections 100 and 162 of the Personal Property Law, McKinney's Consol. Laws of N.Y. Ann., were repealed upon enactment of the Uniform Commercial Code, Section 10-102, which became effective on September 27, 1964.

<sup>6/</sup> In this respect, it is to be noted that taxpayer's action in the New York State Court was based on the promissory notes given to him by Van de Maele and O'Connor, and not upon any purported underlying agreement for the sale of the Graphic Arts stock. Moreover, the judgment of the New York court specifically denied taxpayer's motion for summary judgment insofar as it related to claims "not proved by document." (Ex. Vol. 18-19, 25-27, 35-36.) Therefore, even if it were otherwise relevant for federal income tax purposes, the decision of the New York court does not address itself to whether the several attempted transactions between taxpayer and Van de Maele and O'Connor ever culminated in a sale of any amount of Graphic Arts stock. Cf. Commissioner v. Bosch, 387 U.S. 456 (1967).

of the \$95,000, rather than on the applicable requirement of the federal statute that there be a sale or exchange. See Mechanic v. Commissioner, supra, p. 668. In this respect, the Tax Court's reliance on Lowe v. Commissioner, 44 T.C. 363 (1965), is simply wrong. In Lowe (p. 369), a taxpayer was afforded capital gain treatment because the court found that in the initial sale of the stock involved in that case, the purchasers had acquired "the greater bundle of rights and attributes of ownership, including title, possession and management, and the burdens and benefits accompanying same \* \* \*."<sup>7/</sup> Certainly, this could not be said of anything acquired by Van de Meale and O'Connor in this case.

<sup>7/</sup> The Tax Court in Lowe accordingly regarded the payments retained by the taxpayer under the agreement of sale, when he re-acquired the stock because of the purchaser's failure to perform, as inextricably related to the sale itself and, therefore, capital gain under the doctrine of Arrowsmith v. Commissioner, 344 U.S. 6 (1952). Lowe v. Commissioner, 44 T.C. 363, 373-374 (1965). There are, then, circumstances where capital gain or loss treatment has been deemed appropriate because there occurred in the first instance an actual sale or exchange of some underlying asset. But in such cases, whether they involve an interest under a lease, or the purchase of real estate, or an option or right to purchase an interest in a business, the taxpayer engaged in a capital transaction whereby he transferred possession of the asset in question to another. See generally, United States Freight Co. v. United States, 422 F. 2d 887 (Ct. Cl., 1970). Cf. Turzillo v. Commissioner, 346 F. 2d 884 (C.A. 6, 1965); Bisbee-Baldwin Corp. v. Tomlinson, 320 F. 2d 929 (C.A. 5, 1963); Metropolitan Building Co. v. Commissioner, 282 F. 2d 592 (C.A. 9, 1960); Commissioner v. Paulson, 123 F. 2d 255 (C.A. 8, 1941). They do not deal with a situation where a taxpayer at all times retained the asset because the contemplated sale was never completed, and moreover received amounts merely in respect of the agreement pursuant to which the sale was to be made but under which the sale never, in fact, culminated. Smith v. Commissioner, 50 T.C. 273, 279-280 (1968). Cf. United States Freight Co. v. United States, supra, p. 894.

II

TAXPAYER IS NOT ENTITLED TO REPORT THE  
\$95,000 IN PAYMENTS ON THE INSTALLMENT  
METHOD OF REPORTING

As this Court most recently recognized in Sirbo Holdings, Inc. v. Commissioner, 476 F. 2d 981, 988 (C.A. 2, 1973), the requirements of installment reporting are to be faithfully and strictly construed. Certainly, to the extent that the \$95,000 in issue constituted ordinary income to taxpayer by virtue of the fact that such amount was not received by him from the sale or exchange of his Graphic Arts stock, as we have demonstrated above, so it must follow that there was no "sale or other disposition \* \* \*" of such stock for the purposes of Section 453(b)(1)(B) of the Code, Appendix, infra. So much is required by this Court's decision in Billy Rose's Diamond Horseshoe, Inc. v. United States, 448 F. 2d 549 (C.A. 2, 1971).<sup>8/</sup>

Cf. Dennis v. Commissioner, 473 F. 2d 274 (C.A. 5, 1973).

But even beyond this requirement, taxpayer cannot otherwise avail himself of the benefits of Section 453. Under Section 453 (a)(1), Internal Revenue Code of 1954, Appendix, infra, taxpayer must prove with certainty the various elements of the formula by which installment profits are to be computed: to-wit, the "total contract price" and the "gross profit" from the sale. And in

<sup>8/</sup> This same result also is required under the dicta concerning the Billy Rose case in Sirbo Holdings, Inc. v. Commissioner, 476 F. 2d 981 (C.A. 2, 1973). It simply cannot be said that taxpayer sold, exchanged or otherwise disposed of his Graphic Arts stock or any rights therein either under the reasoning of Billy Rose or Sirbo Holdings.

this respect, the shifting sands of taxpayer's several arrangements with Van de Maele and O'Connor variously involved different numbers of shares of his Graphic Arts stock and successively greater amounts in notes and other obligations to be paid to taxpayer. These circumstances make it "impossible to determine the total contract price [as well as the gross profit], and therefore impossible to calculate the ratable portion of each payment which represented gain under installment payments."

Gralapp v. United States, 458 F. 2d 1158, 1160 (C.A. 10, 1972).<sup>9/</sup>

### III

THE TAX COURT ERRED IN FAILING TO APPLY  
THE APPLICABLE REQUIREMENTS OF SECTION  
274 OF THE INTERNAL REVENUE CODE OF 1954  
FOR DEDUCTION OF EXPENSES IN RESPECT OF  
AN ENTERTAINMENT FACILITY

#### A. General

Section 274, Appendix, infra, was added to the Internal Revenue Code of 1954 by Section 4(a)(1) of the Revenue Act of 1962, P.L. 87-334, 76 Stat. 960, and is applicable to taxable years ending after December 31, 1962. The manifest intention of the provision was to eliminate tax abuses which had developed in respect of entertainment expense deductions. H. Rep. No. 1447, 87th Cong., 2d Sess., p. 19 (1962-3 Cum. Bull. 405, 423); S. Rep.

<sup>9/</sup> We note that the agreed computation in this case (R. 177, 179) and the Tax Court's decision (R. 180-181) apparently does not reflect an adjustment for taxpayer's \$200 basis in the Graphic Arts stock as disclosed on his 1963 return. Taxpayer, then, should be afforded an adjustment in respect of his basis in the stock upon recomputation of the tax pursuant to this Court's decision.

No. 1881, 87th Cong., 2d Sess., p. 25 (1962-3 Cum. Bull. 707, 731). Section 274 is strictly a disallowance provision, the terms of which must be met in addition to other affirmative provisions of the Code which permit the deductibility of particular expenses. H. Rep. No. 1447, supra, p. 19 (1962-3 Cum. Bull., p. 423); S. Rep. No. 1881, supra, pp. 27, 30, 169 (1962-3 Cum. Bull., pp. 733, 736, 873). See Sanford v. Commissioner, 50 T.C. 823, 826 (1968), aff'd per curiam, 412 F. 2d 201 (C.A. 2, 1969).

More specifically, in respect of the deductibility of expenses related to entertainment facilities, Section 274(a)(1)(B) denies any deduction unless the taxpayer shows (i) that the facility was "used primarily for the furtherance of the taxpayer's trade or business" and, (ii) that the particular expenses were "directly related to the active conduct of such trade or business." Section 274(d), in addition, imposes upon the taxpayer the responsibility of substantiating the expenses claimed and <sup>10/</sup> the business relationship thereof.

<sup>10/</sup> Pursuant to the express grant of authority in Section 274(n), Treasury Regulations have been promulgated which explain the disallowance and substantiation provisions of the statute. These Regulations have previously been upheld and applied by this and other courts. Sanford v. Commissioner, 412 F. 2d 201 (1969), aff'd 50 T.C. 823 (1968); Hippodrome Oldsmobile, Inc. v. United States, 474 F. 2d 959 (C.A. 6, 1973); D.A. Foster Trench-  
ing Co., Inc. v. United States, 473 F. 2d 1393 (Ct. Cl., 1973); Andress v. Commissioner, 51 T.C. 803 (1969), aff'd per curiam, 423 F. 2d 679 (C.A. 5, 1970); Fiorantino v. Commissioner, 29 T.C.M. 1445 (1970), supplemental opinion, 29 T.C.M. 1665 (1970), aff'd, 455 F. 2d 1400 (C.A. 2, 1971).

B. Taxpayer failed to establish that his yacht was used primarily in furtherance of his trade or business under Section 274(a)(1)(B)

Section 274(a)(1)(B) of the Code provides that a deduction for expenses relating to an entertainment facility will be disallowed "unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business." (Emphasis added.) Section 1.274(e)(4) (iii) of the Treasury Regulations on Income Tax (1954 Code), Appendix, infra, follows the Congressional Committee Reports in providing that the "primary use" of a facility is established by a showing that "more than 50 percent of the total calendar days of use of the facility \* \* \* during the taxable year were days of business use." See H. Rep. No. 1447, supra, p. 22 (1962-3 Cum. Bull., p. 426); S. Rep. No. 1881, supra, pp. 31, 170 (1962-3 Cum. Bull., pp. 737, 874). This test in the Regulations is augmented, in turn, by certain substantiation provisions, relating specifically to facilities, requiring the taxpayer to maintain records <sup>11/</sup> in respect of both business-related as well as personal use. Regulations, §1.274-5(c)(6)(iii)(a) and (b), Appendix, infra.

The record in this case discloses no evidence whatsoever either as to taxpayer's total use of the yacht, or as to the clearly nondeductible personal use of the facility. Indeed, the Tax Court expressly acknowledged that taxpayer "did not account

<sup>11/</sup> While Section 1.274-5(c)(6)(iii) speaks in terms of "records", the appeal in this case involves, in respect of this particular point, a question of whether the taxpayer adduced in any form the requisite substantiation of the various uses of the entertainment facility.

for all occasions on which the yacht" was used by him (R. 174), and yet, somewhat paradoxically, concluded that the boat was primarily used for business purposes. Such a decision simply cannot abide the clear imperative of the statute and Regulations that taxpayer meet the requirement of showing the facility was "used primarily" for business purposes by a precise accounting of the days of use. Fiorentino v. Commissioner, 29 T.C.M. 1445 (1970), supplemental opinion, 29 T.C.M. 1665 (1970), aff'd, 455 F. 2d 1406 (C.A. 2, 1971), (where a guest book of persons entertained on taxpayer's boat, his own testimony and that of his secretary and business associates, were held cumulatively insufficient to establish that the boat was used primarily for business because not all the occasions of use were accounted for, and there was no adequate evidence of the business purpose of the entertainment, or of the business relationship of the persons entertained for the days of alleged business use); Andress v. Commissioner, 51 T.C. 863 (1969), aff'd, per curiam, 423 F. 2d 679 (C.A. 5, 1970), (where taxpayer, an attorney, was denied deductions for certain club dues because he did not establish that such facilities were used "primarily" for business by showing the total use, the non-deductible personal use, and the business uses of such facilities); Nicholls, North, Buse Co. v. Commissioner, 56 T.C. 1225 (1971) (boat held not primarily used for business where taxpayer's boat log and testimony of its sales manager-director and that of others, at most, established the total days of use, but did not show, among other things, that the days of business use exceeded the days of non-deductible

personal use); Ashby v. Commissioner, 50 T.C. 409 (1968) (where it was held that taxpayer's boat was not "used primarily" for business because, although taxpayer established total use of its boat, it did not prove that more than 50 percent of the days of use were business-related by adducing evidence of the business purpose of each such purported use, and the business relationship of the persons entertained).

Taxpayer's summaries (Ex. Vol. 95-99, 102-104, 106-108) certainly do not meet this requirement.<sup>12/</sup> His secretary, who prepared the summaries and maintained the underlying telephone logs and diaries on which they were based, admitted that these listings did not include an accounting of every use taxpayer made of his yacht, but only those specific uses arranged through his office. (R. 95.) And even in respect of the limited use of the yacht covered by these summaries, there is no evidence in the record, derived from any source, as to the business purpose or business relationship of the persons entertained on each occasion. Treasury Regulations on Income Tax (1954 Code), §§1.274-5(c)(6)(iii)(a) and 1.274-5(b)(1), Appendix, infra; Fiorentino v. Commissioner, supra.

<sup>12/</sup> The Tax Court itself recognized as much after all this documentary evidence (R. 92, 99, 122-124, 128, 150) had been presented to the court. (R. 122.):

THE COURT: \* \* \* the Court would remind you that for the 274 years we have to have an enumerator [sic] and denominator, and there is no way from the information which has been submitted thus far to arrive at any ratio, and the law says it has to be used primarily, and that has been construed to be more than half.

Aside from these summaries, taxpayer's testimony that the yacht was used by him primarily for business purposes was otherwise uncorroborated by any other evidence in the record. Congress made very clear its intention that Section 274 would import into the area of entertainment expense deductions certain objective standards and various requirements of detailed substantiation. H. Rep. No. 1447, 87th Cong., 2d Sess., pp. 22-23 (1962-3 Cum. Bull. 405, 426-427). And this Court has accordingly recognized that a taxpayer must establish the requisite business nature and relationship of the entertainment expenses claimed. Fiorentino v. Commissioner, supra; Hughes v. Commissioner, 437 F. 2d 975 (C.A. 2, 1971); Steel v. Commissioner, 437 F. 2d 71 (1971). See Andress v. Commissioner, supra; Nicholls, North, Buse Co. v. Commissioner, supra; Ashby v. Commissioner, supra. In respect of the deductibility of expenses relating to entertainment facilities, this requirement, as enunciated in Section 274(a)(1)(B), makes it incumbent upon taxpayer to show, on an occasion-by-occasion basis, that his yacht was "used primarily" for business purposes. Fiorentino v. Commissioner, supra; Nicholls, North, Buse Co. v. Commissioner, supra, p. 1225; Ashby v. Commissioner, supra, pp. 415-417. There simply is no evidence in the record which fulfills this requirement.

C. The Tax Court neglected to consider or apply the requirement of Section 274(a)(1)(B) that the expenses in respect of facilities must be "directly related to the active conduct" of the taxpayer's trade or business

Even a superficial reading of the Tax Court's opinion reveals that the court never considered the requirement of the statute that the particular expenses claimed must also themselves be "directly related to the active conduct" of business. Sec. 274(a)(1)(B). Under the statute, taxpayer must fulfill this requirement in respect of each "item" of expense, in addition to meeting the threshold test of otherwise establishing that the facility itself was used primarily for business purposes. Sec. 274(a)(1)(B); Treasury Regulations on Income Tax (1954 Code), §§1.274-2(a)(2), (c)(3)(i)-(iv), and (e). <sup>13/</sup> See Hippodrome Oldsmobile, Inc. v. United States, 474 F. 2d 959 (C.A. 6, 1973).

The record discloses that, at most, taxpayer used his yacht as a means of generating goodwill among persons he hoped would become his clients. (R. 88, 90, 102-103, 127-129.) And it has been most recently held in Hippodrome Oldsmobile, Inc. v. United States, supra, p. 960, that "as a matter of law \* \* \* deductions claimed by the taxpayer for entertainment of customers," the purpose of which was to casually establish goodwill, are "not

<sup>13/</sup> I.e., if a taxpayer used a facility for business 75% of the time, this would not justify an across-the-board deduction of 75% of all his expenses in connection therewith. D.A. Foster Trenching Co. v. United States, 473 F. 2d 1398, 1401 (Ct. Cl., 1973).

'directly related to \* \* \* the active conduct of the taxpayer's \* \* \* business.' " This same conclusion was also reached by the Court of Claims in D.A. Foster Trenching Co., Inc. v. United States, supra, p. 1403. Given these clear articulations of the law, it is apparent that the Tax Court should not have permitted taxpayer a deduction in any amount for his boat expenses. See Treasury Regulations on Income Tax (1954 Code), §1.274-2(c)(3) (i)-(iv), Appendix, infra.

As the Hippodrome Oldsmobile case, supra, clearly delineates, expenses in respect of facilities used for the generation of goodwill are simply no longer deductible under the language of Section 274(a)(1)(B). This is apparent from the Congressional Committee Reports, which are set forth at some length in the Sixth Circuit's opinion. Briefly stated, the House's initial draft of Section 274 required that expenses in respect of both entertainment activities and facilities be "directly related to the active conduct" of the taxpayer's trade or business.

(Emphasis added.) H.R. 10650, 87th Cong., 2d Sess. See H. Rep. No. 1447, supra, p. 19 (1962-3 Cum. Bull., p. 423). The House explained these provisions as requiring that a taxpayer show "more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure \* \* \*." H. Rep. No. 1447, supra, pp. 20, A30 (1962-3 Cum. Bull. pp. 424, 528). The Senate, however, thought that the House version was too harsh, and, therefore, suggested various amendments which would have permitted entertainment expense

deductions in respect of "goodwill where a close association is established between the expense and the active conduct of a trade or business."

As the Conference Committee Report reveals, however, the Senate's amendments were only accepted in respect to entertainment activities. H. Conf. Rep. No. 2508, 87th Cong., 2d Sess., p. 15 (1962-3 Cum. Bull. 1129, 1143). Otherwise, and in respect of entertainment facilities, the more stringent requirements of the House bill were retained, and these provisions prohibited the deduction of entertainment expenses incurred merely for the purpose of goodwill. H. Conf. Rep. No. 2508, supra, p. 16 (1962-3 Cum. Bull., p. 1144); Hippodrome Oldsmobile, Inc. v. United States, supra.

Accordingly, in Hippodrome Oldsmobile, Inc. v. United States, supra, p. 960, the Sixth Circuit held that an automobile dealership could not deduct any amount of its expenses for the maintenance and operation of a cabin cruiser upon which it entertained actual and prospective customers where such expenses related only to "soft sell" tactics, and not to the actual conduct of business. The Court of Claims, in D.A. Foster Trenching Co., Inc. v. United States, supra, similarly denied deductions claimed by a construction company for its expenses in entertaining customers aboard the company's pleasure boat as a means of engendering goodwill. Both courts recognized that Congress had specifically disallowed the deduction of such expenses relating to entertainment facilities used for the creation and maintenance of goodwill,

and that expenses of this type, by definition, were not "directly related to the active conduct" of business. Sec. 274(A)(1)(B), Internal Revenue Code of 1954; Treasury Regulations on Income Tax (1954 Code), §§1.274-2(a)(2), (c)(3)(i)-(iv) and (e).

The record in this case, much like those in Hippodrome Oldsmobile, supra, and in D.A. Foster Trenching Co., supra, discloses no evidence that the taxpayer ever engaged in the active conduct of business during any of the activities in which he entertained on his boat. See Regulations, §1.274-2(c)(3)(ii) and (iii), Appendix, infra. The summaries and taxpayer's own testimony reveal no more than particular and limited occasions on which the yacht was used, and in no manner suggest the business nature, whether active or passive, of such use even on these occasions. (F. 87-108, 119-150; Ex. Vol. 95-99, 102-104, 106-108.) Indeed, the ultimate conclusion that one must draw from his testimony was that he purposely avoided any such encroachment on the glamorous atmosphere he wished to create. (R. 89, 91-92, 102, 105.) In all important respects, taxpayer was at most engaging in the creation and maintenance of goodwill in the use of his yacht. And deductions in respect of expenses solely for this purpose, where no actual business is conducted, are clearly disallowed by Section 274(a)(1)(B) of the Code. Hippodrome Oldsmobile, Inc. v. United States, supra; D.A. Foster Trenching Co., Inc. v. United States, supra.

D. The Tax Court erroneously approximated taxpayer's allegedly business-related expenses where Section 274(d) and the underlying regulations require substantiation of such expenses

The Tax Court apparently premised its decision, which allowed taxpayer to deduct 60 percent of his boat expenses for the years 1963 through 1965, on the settlement between the parties in respect of the two previous years not covered by Section 274. (R. 175-176.) But the parties' settlement of issues pertaining to the pre-Section 274 years, which was encouraged by the court (R. 100), has no intrinsic probative value for later years, much less when those years are controlled by the strict substantiation requirements of Section 274(d), Internal Revenue Code of 1954, Appendix, infra, and the Regulations thereunder. One of the clear intentions in the enactment of Section 274 was to overrule the rule in Cohan v. Commissioner, 39 F. 2d 540 (C.A. 2, 1930), in this area, a rule which permitted an approximation of the expenses actually incurred for otherwise deductible purposes. H. Rep. No. 1447, 87th Cong., 2d Sess. pp. 23, A32 (1962-3 Cum. Bull. 405, 427, 530); S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 35, 173 (1962-3 Cum. Bull. 707, 741, 877); Hughes v. Commissioner, 451 F. 2d 975, 976 (C.A. 2, 1971); Paal v. Commissioner, 450 F. 2d 1108, 1109 (C.A. 9, 1971); Sanford v. Commissioner, 50 T.C. 823, 828 (1968), aff'd per curiam, 412 F. 2d 201 (C.A. 2, 1969). The clear effect of the Tax Court's decision in this case, however, was to resurrect Cohan in contravention of the specific contrary legislative intent.

Section 274(d) requires taxpayer to substantiate his expenses by "adequate records" or other "sufficient evidence corroborating his own statement." These substantiation requirements provide that taxpayer must establish in respect of each use of a facility the precise amount of the expense claimed, the time and place of the use, the business purpose pertaining thereto, and the business relationship to the taxpayer of the persons using the facility. See §1.274-5(b)(1)(i)-(iv), Treasury Regulations on Income Tax. The record before the Tax Court contained no evidence which in any manner approached these substantiation requirements. The summaries introduced into evidence by taxpayer merely suggested the fees paid to his law firm by persons who were incidentally entertained on his boat. But the requirements of Section 274 prohibit a taxpayer from bootstrapping his way into a deduction by merely suggesting that in some instances expenses incurred for the purpose of generating goodwill, actually succeeded in producing revenues for his business. See Hippodrome Oldsmobile, Inc. v. United States, 474 F. 2d 959 (C.A. 6, 1973).

To be sure, there exists a stipulated amount of taxpayer's total boat expenses for each of the years in issue; but taxpayer must substantiate these expenses, and Section 274(d), at the least, requires him to establish the business purpose of each expense and business relationship of the persons using the yacht in respect of each occasion of use for which he claims a deduction. In no other manner is it possible to determine the alloca-

ble portion of the total expenses which would be properly attributable to deductible business purposes. The summaries do not fulfill this requirement, for they are merely composite lists of the persons entertained, and then only on some occasions; they are otherwise devoid of any substantiation which identifies the business purpose of the use or the business relationship to taxpayer of the persons entertained on the yacht.

Taxpayer otherwise failed to meet each of the required elements of substantiation by his own testimony. In this respect, it is to be noted that this case is quite unlike La Forge v. Commissioner, 434 F. 2d 379, 372 (C.A. 2, 1970), holding that a surgeon, who customarily purchased lunch for his assistants at a hospital cafeteria where receipts were not given, could fulfill the substantiation requirements of the statute by his own statement and other corroborative evidence, if both were "sufficiently precise" so as to satisfy each element of substantiation. It is apparent, however, that in La Forge there existed a rather unusual and externally imposed set of circumstances, not present in this case, which justified acceptance of the taxpayer's own statement, together with the complementary corroboration, because of the inherent problems of record-substantiation in that case. In any event, subsequent to the decision in La Forge, this Court has recognized in cases arising under Section 274 that a taxpayer cannot thus substantiate the expenses claimed where his own statement and the evidence offered in corroboration, themselves, fail to fulfill each of the specific substantiation

requirements of the statute. Steel v. Commissioner, 437 F. 2d 71, 73 (C.A. 2, 1971); Hughes v. Commissioner, 451 F. 2d 975, 978-979 (C.A. 2, 1971). In the instant case, taxpayer never established that any part of the boat expenses on any occasion were attributable to a definite business purpose in respect of persons having a specific business relationship to him. Nor did he ever establish what particular components of his total boat expenses were directly related to occasions, described by time and place, which involved his alleged use of the yacht for business purposes. Rather, the 60 percent figure was simply adopted by the Tax Court on the basis of the settlement pertaining to the pre-Section 274 years.

The clear intent of Congress was that "no deduction is [to be] allowed solely on the basis of \* \* \* [a taxpayer's] own unsupported, self-serving testimony." H. Rep. No. 1447, supra, p. 23 (1962-3 Cum. Bull., p. 427); S. Rep. No. 1881, supra, p. 35 (1962-3 Cum. Bull., p. 741). Taxpayer failed totally to meet any of the substantiation requirements either by his own testimony, or that of his secretary, who merely prepared the summaries and had no specific knowledge of the particular nature of taxpayer's use of the yacht, or by the summaries themselves. As a matter of law the settlement for the pre-Section 274 years was manifestly inadequate proof.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court should be reversed.

Respectfully submitted,

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APRIL, 1974.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 17<sup>th</sup> day of April, 1974, in an envelope with postage prepaid, properly addressed as follows:

Robert Trien, Esquire  
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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 274 [as added by Sec. 4(a)(1), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960]. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) Entertainment, Amusement, or Recreation.--

(1) In general.--No deduction otherwise allowable under this chapter shall be allowed for any item--

(A) Activity.--With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility.--With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

and such deduction shall in no event exceed the portion of such item directly related to, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

\* \* \*

(d) Substantiation Required.--No deduction shall be allowed--

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

\* \* \*

(h) Regulatory Authority.--The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section, including regulations prescribing whether subsection (a) or subsection (b) applies in cases where both such subsections would otherwise apply.

SEC. 453. INSTALLMENT METHOD.

(a) [as amended by Sec. 3(a), Act of August 31, 1964, P.L. 88-539, 78 Stat. 746] Dealers in Personal Property.--

(1) In General.--Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

(b) Sales of Realty and Casual Sales of Personality.--

(1) General rule.--Income from--

\* \* \*

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding \$1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

\* \* \*

SEC. 1222. OTHER TERMS RELATED TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

\* \* \*

(3) Long-term capital gain.--The term "long term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

\* \* \*

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.274-2 Disallowance of deductions for certain expenses for entertainment, amusement, or recreation.

(a) General rules-- \* \* \*

(2) Entertainment facilities. Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Code shall be allowed for any expenditure with respect to a facility used in connection with entertainment unless the taxpayer establishes--

(i) That the facility was used primarily for the furtherance of the taxpayer's trade or business, and

(ii) That the expenditure was directly related to the active conduct of such trade or business.

Such deduction shall not exceed the portion of the expenditure directly related to the active conduct of the taxpayer's trade or business.

\* \* \*

(c) Directly related entertainment--

\* \* \*

(3) Directly related in general. Except as provided in subparagraph (7) of this paragraph, an expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that it meets all of the requirements of subdivisions (i), (ii), (iii), and (iv) of this subparagraph.

(i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.

(ii) During the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit (or, at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer's control).

(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the

taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control). It is not necessary that more time be devoted to business than to entertainment to meet this requirement. The active conduct of trade or business is considered not to be the principal character or aspect of combined business and entertainment activity on hunting or fishing trips or on yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary.

(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer's control. For expenditures closely connected with directly related entertainment, see paragraph (d)(4) of this section.

\* \* \*

(e) Expenditures with respect to entertainment facilities--(1) In general. Any expenditure with respect to a facility used in connection with entertainment shall not be allowed as a deduction except to the extent it meets the requirements of paragraph (a)(2) of this section.

\* \* \*

(4) Determination of primary use--

\* \* \*

(iii) Entertainment facilities in general. A taxpayer shall be deemed to have established that--

(a) A facility used in connection with entertainment, such as a yacht or other pleasure boat, hunting lodge, fishing camp, summer home or vacation cottage, hotel suite, country club, golf club or similar

social, athletic, or sporting club or organization, bowling alley, tennis court, or swimming pool, or,

(b) A facility for employees not falling within the scope of section 274(e)(2) or (5)

was used primarily for the furtherance of his trade or business if he establishes that more than 50 percent of the total calendar days of use of the facility by, or under authority of, the taxpayer during the taxable year were days of business use. Any use of a facility (of a type described in this subdivision) during one calendar day shall be considered to constitute a "day of business use" if the primary use of the facility on such day was ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder. For the purposes of this subdivision, a facility shall be deemed to have been primarily used for such purposes on any one calendar day if the facility was used for the conduct of a substantial and bona fide business discussion (as defined in paragraph (d) (3)(i) of this section) notwithstanding that the facility may also have been used on the same day for personal or family use by the taxpayer or any member of the taxpayer's family not involving entertainment of others by, or under the authority of, the taxpayer.

\* \* \*

§1.274-5 Substantiation requirements.

(a) In general. No deduction shall be allowed for any expenditure with respect to--

(1) Traveling away from home (including meals and lodging) deductible under section 162 or 212,

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e), or

(3) Gifts defined in section 274,

unless the taxpayer substantiates such expenditure as provided in paragraph (c) of this section. This

limitation supersedes with respect to any such expenditure the doctrine of Cohan v. Commissioner (C.C.A. 2d 1930) 39 F. 2d 540. The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expenses but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction shall be allowed a taxpayer for such expenditures on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term "entertainment" means entertainment, amusement, or recreation, and use of a facility therefor; and the term "expenditure" includes expenses and items (including items such as losses and depreciation).

(b) Elements of an expenditure--(1) In general. Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;

(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;

(iii) Business purpose; and

(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

\* \* \*

(c) Rules for substantiation-- \* \* \*

\* \* \*

(6) Special rules-- \* \* \*

\* \* \*

(iii) Primary use of a facility. Section 274(a) (1)(B) provides that no deduction shall be allowed for any item with respect to a facility used in connection with an entertainment activity unless the taxpayer establishes that the facility was used primarily for the furtherance of his trade or business. A determination whether a facility was used primarily for the furtherance of the taxpayer's trade or business will depend upon the facts and circumstances of each case. In order to establish that a facility was used primarily for the furtherance of his trade or business, the taxpayer shall maintain records of the use of the facility, the cost of using the facility, mileage or its equivalent (if appropriate), and such other information as shall tend to establish such primary use. Such records of use shall contain--

(a) For each use of the facility claimed to be in furtherance of the taxpayer's trade or business, the elements of an expenditure specified in paragraph (b) of this section, and

(b) For each use of the facility not in furtherance of the taxpayer's trade or business, an appropriate description of such use, including cost, date, number of persons entertained, nature of entertainment and, if applicable, information such as mileage or its equivalent. A notation such as "personal use" or "family use" would, in the case of such use, be sufficient to describe the nature of entertainment.

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

\*

\*

\*



UNITED STATES DEPARTMENT OF JUSTICE

WASHINGTON, D.C. 20530

Address Reply to the  
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5-12924

April 17, 1974

A. Daniel Fusaro, Esquire  
Clerk, U.S. Court of Appeals  
for the Second Circuit  
Room 1702, U.S. Courthouse  
Foley Square  
New York, New York 10007

Re: Philip Handelman and Esther Handelman v.  
Commissioner  
(C.A. 2 - No. 74-1166)

Dear Mr. Fusaro:

We are transmitting herewith for filing with your Court on behalf of the Appellant in the above-entitled case twenty-five copies of the brief and ten copies of the record appendix together with four copies of the exhibit volume.

We are forwarding the additional copies indicated below to counsel for the Appellee, together with a copy of this letter.

Sincerely yours,

Assistant Attorney General  
Tax Division

By: *Meyer Rothwacks*  
MEYER ROTHWACKS  
Chief, Appellate Section

Enclosures

cc: Robert Trien, Esquire  
360 Lexington Avenue  
New York, New York 10017  
Appellant's brief (4 copies)  
Record appendix (4 copies)  
Exhibit volume (1 copy)

